MANUFACTURERS HANOVER

4/4/88 B 5350-3

Economic Report

March – April 1988

Commentary on Pertinent Economic Issues

Up or Down?

Irwin L. Kellner
Chief Economist

How can we tell where we're going, if we can't agree on where we've been? This year's first quarter is now in the record books, yet economists are divided regarding the direction the economy has taken. Most economists feel that business continued to grow in the first quarter–albeit at a slower pace than in the fourth. However, a vocal minority insists that the economy reversed course around the turn of the year, and has contracted, instead. It could make a difference to the outlook if the gross national product rose or fell in the January-March period.

Interestingly, those who think the economy is still growing point to such statistics as the leading indicators. They had fallen three months in a row from October through December, but upon release of the January reading (which was down), December's posting was revised to show an increase. February's reading was up, too. Thus, this key forward-looking index is no longer declining the requisite three consecutive months that lead to talk of recession. Another statistic that boosted the bulls even more was the February labor force data, which showed a whopping 531,000 leap in nonfarm payroll employment–more than twice market expectations.

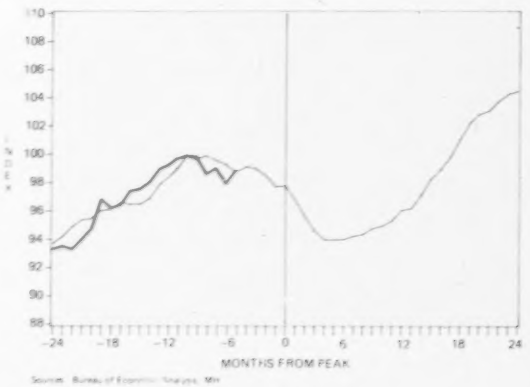
Manufacturers Hanover Economics Department 17/270

Some Misleading Statistics

But there are many signs of weakness that the more bullish economists may be ignoring. Take the leading indicators, for example. Chart I shows this index's current performance, measured against its behavior prior to and after seven previous business cycle peaks. The lines are arranged so that the peak of the current index coincides with the peak of the average of the past. As you can see, this series rarely moves in a straight line for very long, so its current behavior is not at variance with its behavior just prior to past economic peaks.

As for the labor force data, they, too, are not as strong as they appear. A big chunk of the payroll gains came in service industries, much of which appeared to be either low-paying full-time jobs, such as those held by temporary employees, or part-time employment. This is suggested by the fact that the average hourly wage slipped a bit in February.

CHART I
LEADING INDICATORS
CURRENT INDEX (THICK) VS.
AVERAGE OF PRIOR SEVEN RECESSIONS (THIN)



Meanwhile, factory payrolls went up by only 20,000 in the month. When combined with a drop in overtime and in the average workweek, this led to a near cessation of growth in factory output–the sector that was supposed to carry the economy forward this year! Manufacturing production rose at an annual rate of only 1.8 percent in February, after rising at a 7.3 percent pace in the previous four months.

Faulty seasonal adjustments may have also played a role. There were especially large increases in both construction and retail payrolls–rather unusual, when you remember how weak these two sectors were earlier in the year. The pace of new-home construction in the first two months of this year was 6½ percent below the average of the fourth quarter–and ran a thumping 20 percent below year-ago levels. And retail sales excluding autos fell sharply in January and probably dropped further in February, when you factor out inflation.

It's not hard to figure out why the consumer has zipped up his wallet. Savings are low,

Copyright 1988 Manufacturers Hanover Corporation 270 Park Avenue, New York, NY 10017

debt is high, and buying power has stopped growing. Last year, the savings rate dipped to a 40-year low. Not since 1947 was the savings rate as low as it was in 1987. By contrast, over the postwar period, people managed to sock away about 6¾ percent of their take-home pay; in the mid-1970s, people routinely saved more than eight percent of their paychecks.

Debt, on the other hand, is at record levels—not only in absolute terms, but, more important, as a share of after-tax income. If you add up installment and mortgage debt held by individuals at the end of last year, you will see that it equals more than 75 percent of take-home pay! And this is with fewer tax benefits because of tax reform. As for buying power, it hardly grew at all in 1987—gains in employment notwithstanding. This is because many people were unable (or unwilling) to keep up with inflation. Flatness in buying power is usually associated with recessions—not with expansions.

CHART II
REAL RETAIL SALES EXCLUDING AUTOS

Then there is that elusive element called confidence. While several surveys of consumer attitudes do suggest a rebound from the post-crash lows of last October, more telling, perhaps, is what has happened to household net worth as a result of the stock market's plunge. According to the Council of Economic Advisers:

> "... consumer spending behavior appears to have become more cautious. The stock market is a barometer of confidence in the outlook, and it is a major component of the Nation's wealth. At the end of September the market value of corporate equities totaled roughly $4.4 trillion, about $2.3 trillion of which was held directly by the household sector. This $2.3 trillion represented nearly one-sixth of that sector's total net worth of $15 trillion, so a large change in the value of stocks could be expected to have an impact on household spending. Some econometric models have estimated that a $1 decline in the value of the stock market reduces consumer spending by about four cents over a horizon of roughly one year. Thus a $500 billion drop in stocks would mean about a $20 billion (or 0.8 percent) reduction in consumer expenditures by the fall of 1988."

Sales and Output Diverge

Not surprisingly, consumer spending has been weak for quite some time—going back even before the market's crash. Over the past year, consumer outlays excluding automobiles have fallen by one percent, after having risen at a four percent annual rate from the middle of 1984 to early 1987, and at a six percent clip from the beginning of the expansion, to mid-1984 (Chart II).

By contrast, output of consumer goods accelerated early last year. Not surprisingly, a pileup of unsold goods developed at all levels of production and distribution. First apparent at the retail level, excess stockpiles have spread to wholesalers, and are now impacting the nation's manufacturers. That's why factory output has turned sluggish.

As many readers must be aware by now, inventory accumulation accounted for over 80 percent of the growth in the fourth quarter's real GNP. At the same time, consumer spending fell, suggesting that most of this pileup was unintended. Yet, some economists profess not to be worried. They believe that there was some deliberate inventory building because of inflation fears, as well as because of surging exports. And they also think that a big chunk of the pileup of stocks at retail represented goods that came from abroad.

There's not much substance to these arguments. On the inflation front, while there is some price pressure in the production

pipelines (Economic Report–January 1988) it is clearly being capped at the wholesale and at the consumer level because of weak final demands. And if exports are surging, why should finished goods be piling up in warehouses? The ratio of manufacturers' work-in-process inventories to their finished goods inventories is now declining, after having risen sharply during the previous eight months.

As for the source of retail stocks being imports, two points should be noted:

1. Real imports of consumer goods have not grown at all since third-quarter 1986, while real retail inventories have climbed about 10 percent;

2. Regardless, inventories are part of the GNP accounts, thus any efforts to work them down will represent a subtraction from the first quarter's tally.

What about the export sector, you say? Surely there is strength here. Of course there is–but, once again, not as much as meets the eye. For one thing, the export industries account for only about 12 percent of GNP. This means that they would have to grow awfully fast to offset just a flattening in the much larger consumer sector.

For another, many companies that export are running at peak rates of speed: they simply cannot grind out the goods any faster. Even if they could, who would buy the goods, considering how weak Europe is and that we don't sell much to Japan and to Latin America? The fact that exports fell in January by nearly twice as much as they usually do may be an indication that some exporters are bumping up against limits to growth–either in terms of capacity utilization, or in weakness in overseas economies.

Our Shifting Trade Gap

Finally, although American industry has become more competitive compared with Japan and the industrialized nations of Western Europe, it has not materially improved its position against a number of other countries. This is because, while the U.S. dollar has fallen a lot against the Japanese yen, as well as against the currencies of the industrialized European countries, it has not fallen very much either against the currency of our biggest trading partner, Canada, or against the currencies of the so-called "Four Tigers" of the Pacific Basin–South Korea, Singapore, Hong Kong and Taiwan.

Since reaching a peak in late February, 1985, the U.S. dollar has dropped by about 50 percent against the Japanese yen, German mark, Swiss franc and Dutch guilder, and close to 45 percent against the other major European currencies. However, against the Canadian dollar, the U.S. unit has declined by less than 10 percent. And even with the Canadian dollar now at a four-year high, it remains undervalued against the U.S. dollar. This is a major reason why our bilateral trade deficit with Canada remains large.

Far more serious is the dollar's performance against the "Four Tigers." As was first reported 18 months ago (Economic Report–September 1986) these newly industrializing countries of Southeast Asia represent one of the fastest growing components of U.S. trade. Our two-way trade with these countries has increased from $11 billion in 1975, to $85 billion last year. At the same time, our trade deficit with these countries soared from less than $500 million, to $38 billion last year. Three of the four "Tigers" are now in the top ten in terms of our two-way trade, and they are moving up in the deficit rankings, too. Our trade deficit with South Korea ranked number five last year; four years earlier the country wasn't in the top ten. And Taiwan has jumped from our eighth largest deficit trading partner in 1981, to rank number two last year! Thus, even as we are reducing our trade deficit with Japan and Germany, we are increasing it with the Pacific Basin countries. This will limit the overall reduction in our trade deficit, thus its contribution to economic growth.

The bottom line: It appears as though there was little or no growth in the first quarter's GNP. And if this is true, there could well be a repeat performance in the second quarter–especially if inventories remain top-heavy and corporate, consumer and investor attitudes darken. ■

MANUFACTURERS HANOVER

Vitality

"...We look for stronger operating earnings in 1988 based on three fundamentals—further success in managing our businesses for higher returns, lower operating expenses and a continued improvement in credit quality..."

Extracted from a letter to shareholders by the Chairman, John F. McGillicuddy.

"...Restoring common shareholders' equity to four percent, the ratio prior to the reserving action, is our overriding priority. We intend largely to accomplish this objective by the end of 1988 through a combination of gains from the sale of undervalued assets, the realization of tax benefits resulting from the addition to the reserve, and stronger operating earnings...

Asset Sales

"During 1987, as part of the equity restoration process, we realized $150 million pre-tax from the sale of undervalued assets... We continue to have substantial amounts of undervalued assets on our books. By selling a portion of them, we anticipate pre-tax gains in 1988 of $400 million—$230 million after-tax, but before-tax benefits relating to the reserve decision.

Tax Benefits

"In 1987, the full impact of the reserving action was mitigated by the ability to apply $277 million in tax benefits. In 1988, we will have the capacity arising from operating earnings and gains from asset sales to apply approximately $200 million of the remaining $342 million of tax benefits relating to the reserve action.

Operating Earnings

"While tax benefits and special gains will be essential to rebuilding equity in 1988, it is the renewed strength of our basic businesses that will make the major difference this year and in the years ahead.

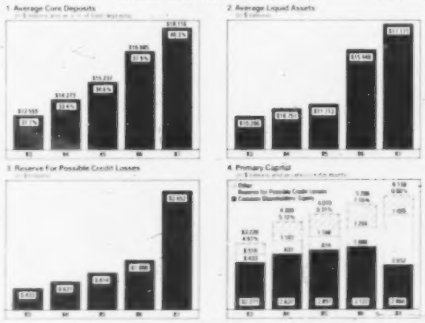
"We look for stronger operating earnings in 1988 based on three fundamentals—further success in managing our businesses for higher returns, lower operating expenses and a continued improvement in credit quality as was evident in the fourth quarter of 1987.

"Manufacturers Hanover has strong franchises in place within profitable segments of three key markets.

"Also in place is an effective profitability discipline to make these businesses pay off in higher returns. It proceeds from the logic that managing for higher returns dictates that we exit, sell or downsize businesses that no longer meet our targets, while directing additional resources to the most profitable segments of our markets. The objective is clear—to enhance shareholder value.

"Managing for higher returns formed the basis of the restructuring and other special charges we took in the fourth quarter amounting to $117 million. This primarily related to the exiting of businesses, a further sharpening of focus in selected markets, the closing of domestic offices and a planned staff reduction of approximately 2,500. With this reduction, total staff will have been scaled down by approximately 5,400 positions, or 17 percent, since the beginning of 1986.

"The restructuring portion of the fourth quarter charges amounted to $82 million, but will result in an earnings benefit going forward of approximately $95 million a year.



"Improved results were largely masked in 1987 by the reserving action in June and the fourth quarter restructuring charge. Progress was broadly based. For example, trading revenues increased 47 percent to $161 million. Earnings from consumer banking increased 22 percent to $116 million. Net income for the Corporate Banking Sector totalled $166 million, up from $40 million in 1986.

"Also masked was our institution's continued success in controlling overhead. Without the restructuring and other special charges, operating expenses would have been up only 3.3 percent for the year—among the best performances for a money center bank. Expense control remains an imperative. We expect operating expenses in 1988 to be lower than last year's level.

"In summary, with a number of major restructurings behind us, the real value of our business franchises will begin to be reflected in stronger operating earnings..."

MANUFACTURERS HANOVER

Manufacturers Hanover Corporation
Bank Window, Church St. Station
New York, N.Y. 10015

First Class Mail
U.S. Postage
PAID
New York, N.Y.
Permit No. 5766

644 644012385 C 928 GARNEOC01
SUSAN GARNER
SRI ACQUISITIONS
CONGRESSIONAL INF. SERVICE
4520 E. W. HIGHWAY, SUITE 800
BETHESDA, MD 20814